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No. 83

In the Supreme Court of the United States

OCTOBER TERM, 1948

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

MARGARET R. PHIPPS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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The taxpayer's brief contains a series of hypothetical examples designed to show that application of the *Sansome* principle to work an inheritance of earnings and profits as such but not to permit a carry-over of deficits as such leads to results which comport neither with sound corporate accounting nor economic reality (Br. 19–28). Before discussing these examples in any detail, we should like, once again, to make reference to some basic factors which the taxpayer seems to ignore.

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First: To note an inconsistency between tax treatment and corporate accounting concepts in this field, as does the taxpayer, is to advance her position not at all. As this Court has but recently said: "'earnings and profits' in the tax sense, although it does not correspond exactly to taxable income, 'does not necessarily follow corporate accounting concepts either.'" *Commissioner* v. *Wheeler*, 324 U. S. 542, 546; rehearing denied, 325 U. S. 892. If the *Sansome* rule means anything, it must involve the expectation that any attempt at translating its effect on application into traditional or standard accounting terms will often lead to disappointment. For the *Sansome* rule almost always has the effect of treating as "earnings and profits" available for distribution as a taxable dividend amounts which have been capitalized on the books of the new corporation and, against which, as an accounting matter, there is a capital stock liability. See, *e. g. United States* v. *Kauffman*, 62 F. 2d 1045, 1046 (C. C. A. 9th); *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641, 642 (C. C. A. 5th); *Barnes* v. *United States*, 22 F. Supp. 282, 283 (E. D. Pa.), per Maris, D. J.

Seconds The taxpayer attempts (Br. 28) to measure the validity of the Commissioner's restriction of the *Sansome* rule to air "earnings and

profits situation against a standard of economic reality. But to make this attempt by dealing only with the effect of this application of the *Sansome* rule on the corporation itself is a doubtful approach generally, and entirely beside the point when, as here, the taxpayer with whose interests this case is concerned is the shareholder, not the corporation.

If we are to speak in terms of "true economic status" (Br. 28), the following facts cannot be ignored. In this case, it is conceded that the corporation of which the taxpayer was a shareholder had accumulated earnings in excess of $2,000,000. After deducting that part of the distribution during the taxable year which was concededly out of current earnings, the amount of the distribution in issue is only $411,896.98. Nothing could be farther from "economic reality" than to conclude that while there were over $2,000,000 in earnings and profits available for distribution, a distribution of about $400,000 was not out of earnings and profits even though the shareholders' corporation had suffered no operating losses of its own and had made no other distributions. If the corporation in which the taxpayer held stock suffered a loss on the liquidations, that is not shown. The realities of the situation thus are that nothing has cut into the accumulated earn-

ings of over $2,000,000 other than, according to the taxpayer, a paper deficit of four corporations in which the taxpayer held no stock.

If the taxpayer's corporation has suffered a loss in an economically "real sense", though one which is not recognized for tax purposes, that loss will be reflected in the value of her stock, and she will, in a very real tax sense, be credited with that loss on ultimate disposition of her stock. See, our principal brief, pp. 39–40.

With these considerations in mind, we turn now to a detailed analysis of the taxpayer's hypotheticals:

A. The fact that the application of the *Sansome* rule even to a situation not involving a predecessor corporation with a deficit will upset the corporate balance sheet may well be illustrated by adopting the first hypothetical case assumed by the taxpayer (Br. 19–20). Corporations A and B have the following balance sheets:

	A	B
Net Assets	$125,000	$75,000
Capital stock	$100,000	$50,000
Earned surplus account	25,000	25,000
	$125,000	$75,000

Assuming that B, in a tax-free merger, is to acquire the assets of A of a value of $125,000 in exchange for its stock, B would, in the ordinary course, have to issue stock in the amount of at least $125,-

000.[1] The balance sheet of B after the acquisition, for accounting purposes, would then be as follows:

Assets	$200,000
Capital stock	225,000
Earned surplus	(25,000)
	$200,000

But under the *Sansome* rule, for tax purposes, the A earnings of $25,000 (reflected in the value of the A assets transferred) would remain earnings in B's hands and would eliminate its deficit, resulting in a zero amount for the earned surplus account. And if these transferred earnings were carried into the balance sheet, B's balance sheet as a consequence of the *Sansome* rule would be unbalanced, reflecting assets of $200,000 and capital stock of $225,000. To show the corporation's position for tax purposes, the balance sheet would have to be reconstructed further, by reducing the capital stock account by the amount of the *Sansome* earnings. For the purposes of getting a tax balance sheet, there could of course be no objection to this step since the *Sansome* rule regards so much of the capital stock shown on B's books as equals the former accumulated earnings of A

[1] The taxpayer's assumption (Br. 20) that, regardless of whether B is merged into A or A into B, the combined capital stock would be $200,000 is we believe, not correct. In the usual business transaction, the stock issued for the assets would normally reflect the value of the assets so acquired. On this basis, the capital stock would not be $200,000 after either merger.

as, in fact, constituting earnings in B's hands despite their capitalization on its books.[2]

It is thus clear that the transfer of accumulated earnings worked by the *Sansome* rule can not be fitted into balance sheet concepts without further adjustments, and, by the same token, balance sheet concepts should not be a factor in determining whether a deficit is to carry over for tax purposes.

B. The taxpayer is mistaken in her suggestion that an inaccurate reflection of gains or losses arises only by virtue of a failure to carry over deficits. This difficulty is inherent in the *San-*

[2] If B were merged into A, A would acquire for $75,000 of its stock the B assets having a value of $75,000. A would then have $200,000 of assets, $175,000 of capital stock and an earned surplus of $25,000. These balance sheet figures would also be the figures for tax purposes, since the B deficit of $25,000, which was not reflected in the value of the assets which A received, does not pass to A. To carry over the deficit would upset the balance sheet.

Contrary to the taxpayer's assertion (Br. 19–20), it does make a difference in so far as the *Sansome* rule is concerned whether B is merged into A or A into B. The problem is to ascertain after each merger for tax purposes the amount in the earned surplus account of the particular corporation which acquired the other's assets. Cf. our principal brief, pp. 44–47. Where B acquires A's assets, B takes assets which in A's hands reflected capital in part and accumulated earnings in part and they continue to have the same status in B's hands in order to insure that the A earnings will not escape taxation as a dividend. This is so even though B has issued stock in the full amount of the assets acquired. On the other hand, if A were to acquire the assets of B, all of the assets would in B's hands have represented capital and they continue to represent capital in A's hands, stock having been issued in the amount of the assets.

some rule even when applied only to situations in which there is no deficit corporation. Thus, the taxpayer sets forth hypothetical cases (Br. 21–28) designed to illustrate her contention that the *Sansome* rule must be applied to deficits as well as earnings in order to reflect the actual but nonrecognizable gain or loss sustained by a parent on liquidation of a subsidiary. But these can be matched with other supposed cases which will show that the reflection of actual gains in the earnings account is not necessarily achieved by the operation of the *Sansome* rule. For example, assume that P company, with cash of $500,000 and capital stock of $500,000, purchases for business reasons the stock of A corporation, originally issued for $200,000, after A has earned $300,000. P in the normal course would pay $500,000 for the A stock. P's balance sheet would then show as an asset stock of A at $500,000 and capital stock of $500,000. P then liquidates A, taking over its assets at a basis of $500,000 and sustaining no gain or loss on the liquidation. Its balance sheet will still show assets (acquired from A) of $500,000 and capital stock of $500,000. Upon disposition of the assets P's actual gain or loss at that time will be recognized and carried into its earned surplus account. Yet notwithstanding that there was no gain or loss on the liquidation and that P's full gain or loss on disposition of the assets will be reflected in its earnings account, the *Sansome* rule operates

to transfer the A earnings of $300,000 to P as earnings for tax purposes. The *Sansome* earnings will of course not appear in P's balance sheet as earnings but will be reflected there in the figure of $500,000 for the capital stock. The result of the *Sansome* rule on these facts is to attribute a gain to P which it does not in fact have.

Assume now that the P company, with cash of $500,000 and capital stock of $500,000, purchases the stock of B corporation, originally issued for $200,000, at a time when B has earned $100,000. P pays $300,000 for the B stock. Thereafter, B earns $100,000 more and P liquidates B, taking over its assets at a basis of $400,000. P has a gain of $100,000 on the liquidation which is not recognized at the time and which will not be taken into account when the assets are disposed of since their basis is $400,000 instead of the $300,000 invested by P. For tax purposes P will, under the *Sansome* rule, be required to treat the former B earnings of $200,000 as its earnings; thus P's earnings for tax purposes increase by $200,000 whereas its gain was only $100,000.[3] Obviously, here too, the *Sansome*

[3] P's balance sheet will reflect the gain but not the *Sansome* transfer as follows:

Assets		*Net Worth*	
Cash	$200,000	Capital stock	$500,000
B assets	400,000	Earned surplus (gain on liquidation)	100,000
	$600,000		$600,000

rule does not correct P's earned surplus account so that it reflects P's actual but nonrecognized gain on the liquidation.

Third, it will be assumed that P, with cash of $500,000 and capital stock of $500,000, purchases the stock of C, originally issued for $200,000, at a time when C has earned $200,000. P is able to make the purchase at a bargain price of $200,000. Thereafter P liquidates C, taking its assets at a basis of $400,000 and realizing a gain of $200,000, which is unrecognized for tax purposes and which will not be reflected in the earned surplus account when the assets, having a $400,000 basis, are disposed of. That gain, though not recognized for tax purposes, will, however, appear as earned surplus on P's balance sheet. At the same time, the *Sansome* rule will transfer C's earnings of $200,000 to P for tax purposes, with the result that P's earned surplus account for tax and for balance sheet purposes will be the same. This result is reached not because the *Sansome* rule is constructed to reflect P's gain; the identity of tax and accounting results is merely a consequence of the particular figures selected.

C. The taxpayer's suggestion that proper accounting and equitable tax treatment can be guaranteed if successor corporations are permitted to inherit the deficits of its predecessors (Br. 28) is an erroneous one. Assume that P, with cash of $500,000 and capital stock of $500,000, buys the

stock of D, originally issued for $500,000, at a time when D has a deficit of $400,000. P pays $100,000 for the D stock and thereafter liquidates D, receiving assets of a value and at a basis of $100,000 and sustaining no gain or loss on the transaction. There is thus no unrecognized gain or loss, which will be unaccounted for when the assets are disposed of. However, if, contrary to our contention, the B deficit of $400,000 is considered to have been transferred to P, for tax purposes P will have a deficit in that amount even though it has in fact sustained no loss. This of course would not reflect the "true economic status" and is not warranted for any other reason.

Again, assume the same facts in respect of corporations P and E, except that, after P acquires E's stock for $100,000, E earns $200,000, reducing its deficit to $200,000. Upon liquidation of E, P takes over assets of $300,000, realizing a gain of $200,000 which is unrecognized at the time and which will not be accounted for when the assets are disposed of since their basis in P's hands is $300,000. If, contrary to our contention, the E deficit of $200,000 carries over to P, for tax purposes P will show a deficit of $200,000 when in fact it has had a gain of $200,000. To permit the deficit transfer there would completely depart from the true economic situation.

It is believed that the foregoing examples are sufficient to show that the transfer of earnings

pursuant to the *Sansome* rule does not necessarily adjust the earnings account to reflect a gain, nonrecognizable for tax purposes but realized by the parent on liquidation of a subsidiary, although it may by coincidence do so in some cases. They also show that the transfer of a deficit, if that were authorized, would not necessarily adjust the surplus account to reflect a nonrecognizable but realized loss. It follows that the *Sansome* rule is not to be enlarged to transfer deficits on the theory that to do so will reflect the true economic realities for balance sheet purposes or for tax accounting purposes.[1]

The plain fact is that the purpose of the *Sansome* rule is not to adjust the earnings account to reflect an unrecognized gain sustained on a liquidation, but, as was shown in our principal brief (pp. 15–22), is to preserve the predecessor's earnings as earnings in the hands of the reorganized or parent corporation so that they will be taxed to

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[1] As pointed out in our principal brief (pp. 30, 32, 37), the stipulation in this case is insufficient to show whether the parent corporation sustained gain or loss on the liquidations of the five subsidiary corporations in 1936.

[2] The typical reorganization for *Sansome* rule purposes is that in which the A corporation, in exchange for assets of B corporation, issues its stock or securities to B corporation or to the B stockholders. It would be a rare case indeed if A were to realize a gain on such a transaction. The *Sansome* rule was developed to meet that situation, however, and these considerations cogently confirm the point that a purpose to adjust the earnings accounts to reflect an unrecognized gain played no part in the development of the *Sansome* rule.

stockholders upon their distribution. The rule has justification in the fact that, apart from any gain or loss on the transactions, the reorganized or liquidated corporation has received the predecessor's assets, some of which reflect the amount of its accrued earnings. As previously emphasized, the rule is not required in the case of a deficit corporation which has no earnings to escape tax, nor is there justification for treating the deficit as continuing in the successor corporation's hands, because none of the assets it receives from the predecessor reflect or represent the predecessor's deficit.

CONCLUSION

The judgment of the Court of Appeals should be reversed.

Respectfully submitted.

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